

**BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA**



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Order Instituting Investigation to Consider Policies to Achieve the Commission's Conservation Objectives for Class A Water Utilities.	Investigation 07-01-022 (Filed January 11, 2007)
In the Matter of the Application of Golden State Water Company (U 133 W) for Authority to Implement Changes in Ratesetting Mechanisms and Reallocation of Rates.	Application 06-09-006 (Filed September 6, 2006)
Application of California Water Service Company (U 60 W), a California Corporation, requesting an order from the California Public Utilities Commission Authorizing Applicant to Establish a Water Revenue Balancing Account, a Conservation Memorandum Account, and Implement Increasing Block Rates.	Application 06-10-026 (Filed October 23, 2006)
Application of Park Water Company (U 314 W) for Authority to Implement a Water Revenue Adjustment Mechanism, Increasing Block Rate Design and a Conservation Memorandum Account.	Application 06-11-009 (Filed November 20, 2006)
Application of Suburban Water Systems (U 339 W) for Authorization to Implement a Low Income Assistance Program, an Increasing Block Rate Design, and a Water Revenue Adjustment Mechanism.	Application 06-11-010 (Filed November 22, 2006)
Application of San Jose Water Company (U 168 W) for an Order Approving its Proposal to Implement the Objectives of the Water Action Plan.	Application 07-03-019 (Filed March 19, 2007)

**OPENING BRIEF – PHASE 1B –
OF CALIFORNIA WATER ASSOCIATION**

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SUBJECT INDEX

	Page
I. INTRODUCTION	2
A. The Pending Settlement Agreements and the ROE Issue	3
B. The Testimony of Expert Witnesses.....	4
C. CWA’s Position: No ROE Adjustments; Defer Consideration, If Any, To Utility-Specific Cost of Capital Proceedings	7
II. ARGUMENT	8
A. DRA’s Recommendation for an ROE Reduction Has No Basis in Financial Theory, Fact or Public Policy	8
1. DRA’s Recommended ROE Reduction Is Not Supported by Established Principles of Finance Theory.....	8
2. Market Responses to Adoption of Revenue Adjustment Mechanisms for Gas Utilities Indicate No Change in Overall Risks of the Utilities.....	16
3. Credit Ratings Agencies’ Responses to the Adoption of Energy Revenue Adjustment Mechanisms for California Energy Utilities Indicate No Change in Overall Risks of the Utilities	20
4. DRA’s Recommended ROE Reduction Is Contrary to and Inconsistent with Commission Policy on Water Conservation.....	22
B. DRA’s Specific Recommendation for a 50 to 100 Basis Point ROE Reduction Also Has No Basis and Is Completely Arbitrary.....	24
C. Company Specific ROE Determinations Should Be Made in the New Water Utility Cost of Capital Proceedings Where All Risk Factors Can Be Considered Together	27
1. Increases in Regulatory Risk	28
2. Increases in Water Quality Risk	29
3. Increases in Supply Availability Risk.....	30
D. The Commission Has Never Reduced Any Utility’s Authorized Return On Equity Solely Based on Implementation of a Revenue Adjustment Mechanism, and It Should Not Do So Here	33

SUBJECT INDEX

	Page
E. WRAMs and MCBAs Represent A Balanced Regulatory Mechanism That Provides Benefits to Ratepayers and Facilitates the Public Policy Goal of Water Conservation	42
F. DRA’s Recommendation for an ROE Adjustment Will Adversely Impact the Water Utilities’ Access to Capital at a Time When Capital Is Critically Needed	45
III. CONCLUSION	47

TABLE OF AUTHORITIES

Page

CALIFORNIA PUBLIC UTILITIES COMMISSION CASES

<i>Investigation into Measures to Mitigate the Effects of Drought</i> Decision 91-10-042, 41 CPUC 2d 521, 1991 Ca. PUC LEXIS 697	34
<i>Re Supply Adjustment Mechanisms for Natural Gas Utilities,</i> Decision 88835, 1978 Cal. PUC Lexis 62; 84 CPUC 5, adopted May 16, 1978	35, 36
<i>Re Pacific Gas and Electric Co.,</i> Decision 89316, 1978 Cal. PUC Lexis 973; 84 CPUC 248, adopted September 6, 1978.....	36, 37
<i>Re Pacific Gas and Electric Co.,</i> Decision 93887, 1981 Cal. PUC Lexis 1279, 7 CPUC 2d 349, adopted December 30, 1981	39
<i>Re San Diego Gas & Electric Co.,</i> Decision 93892, 1981 Cal. PUC Lexis 1284, 7 CPUC 2d 584, adopted December 30, 1981	40
<i>Re Southern California Edison Co.,</i> Decision 82-12-055, 1982 Cal. PUC LEXIS 1209, 10 CPUC 2d 155, adopted December 13, 1982	40, 41
<i>Re Southern California Gas Co.,</i> Decision 89710, 1978 Cal. PUC Lexis 1506; 84 CPUC 657, adopted December 12, 1978	38
<i>Re Southwest Gas Co.,</i> Decision 89706, 1978 Cal. PUC Lexis 1510, 84 CPUC 634, adopted December 12, 1978	37, 38

FEDERAL STATUTES

Safe Water Drinking Act	29
Tax Reform Act of 1981	39

TABLE OF AUTHORITIES

Page

CALIFORNIA PUBLIC UTILITIES COMMISSION RULES OF PRACTICE AND PROCEDURE

Rule 13.11	1
------------------	---

OTHER AUTHORITIES

Beaver, Kettle and Scholes, “The Association Between Market and Accounting Determined Risk Measures”, <i>Accounting Review</i> 45 (1970)	11, 12, 13, 14, 15, 16
California Public Utilities Commission Water Action Plan, adopted December 15, 2005	3, 7, 22
John, John and Reisman, “Accounting Data and Asset Valuation: Theory”, <i>Review of Quantitative Finance and Accounting</i> 4 (1994)	11, 14, 16

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**OPENING BRIEF – PHASE 1B –
OF CALIFORNIA WATER ASSOCIATION**

Pursuant to Rule 13.11 of the Commission's Rules of Practice &
Procedures and in accordance with the schedule established by ALJ Grau at the last day

of evidentiary hearings on November 27, 2007, California Water Association (“CWA”) files its opening brief in Phase 1B of this proceeding.

CWA is a trade association comprised of many of the investor-owned water utilities regulated by this Commission, including seven of the 10 Class A water utilities subject to Commission jurisdiction. CWA regularly represents the investor-owned water utility industry before the Commission and the California Legislature on matters of common interest to the industry. It has participated on many occasions and in many proceedings before the Commission. The following Class A water utility members of CWA join in this opening brief: California American Water Company (“California American Water”), California Water Service Company (“Cal Water”), Golden State Water Company (“Golden State”), San Jose Water Company (“SJWC”), and Suburban Water Company (“Suburban”).

I. INTRODUCTION

This investigatory proceeding to consider policies to achieve the Commission’s water conservation objectives for Class A water utilities has been consolidated with the separate applications of Cal Water, Golden State, SJWC, Suburban and Park Water Company (“Park Water”), all of which propose certain rate designs and other ratemaking mechanisms aimed at promoting water conservation in California, while removing financial disincentives that might impede the water utilities’ efforts to promote conservation. Among these ratemaking mechanisms proposed by the utility applications consolidated with this investigation are a water revenue adjustment mechanism (“WRAM”) and a modified cost balancing account (“MCBA”). A WRAM would decouple the actual sales of water from the forecasted revenue requirement a utility needs

to meet its fixed costs of providing water service, thereby removing any financial disincentive a utility may have to encourage its customers to conserve (*i.e.*, use less) water.¹ An MCBA is a balancing account that tracks the difference between a utility's actual variable costs and adopted variable costs of principally purchased water, purchased power and pump taxes.

A. The Pending Settlement Agreements and the ROE Issue.

Separate settlement agreements regarding the details of the WRAMs and MCBAs (as well as specific conservation rate designs) have been entered into by Cal Water, the Division of Ratepayer Advocates (“DRA”) and The Utility Reform Network (“TURN”), by Golden State and DRA, and by Park Water and DRA. Separate motions for approvals of these settlements are pending before the Commission. SJWC and Suburban also entered into separate settlement agreements with DRA on their water conservation applications, but neither of these settlements involve the adoption by SJWC or Suburban of conventional WRAMs or MCBAs.

Phase 1B of this proceeding considers whether the adoption of WRAMs and MCBAs should be accompanied by a corresponding reduction in a utility's return on equity (“ROE”) as a result of what DRA alleges to be a reduction in the water utilities' risk profiles.² DRA alleges that a combination of WRAMs and MCBAs will reduce water utilities' accounting earnings variability and help them more consistently achieve their authorized rates of return. DRA argues that lower accounting earnings variability

¹ The decoupling of water utility sales from earnings was specifically mentioned by the Commission in its December 2005 Water Action Plan as a means of promoting water conservation. This investigatory proceeding and the consolidated applications are a result of the Commission's goals and objectives, as expressed in the Water Action Plan, for promoting water conservation.

² Except for SJWC and Suburban, the settlement agreements between DRA and the water utilities (and TURN in Cal Water's application) do not include a settlement on the issue of whether a reduction in ROE should accompany the implementation of the WRAMs and MCBAs.

translates one-for-one into lower systematic risk for the utilities and thus into lower authorized returns on equity.

B. The Testimony of Expert Witnesses.

At the November 15-16, 19-21, and 26, 2007 Phase 1B evidentiary hearings, DRA presented its witness, Terry L. Murray, who testified that WRAMs will reduce the water utilities' accounting earnings variability and thus reduce the utilities' risk profiles. Ms. Murray also recommended an immediate 50 to 100-basis point reduction in the existing, authorized ROEs of Cal Water, Golden State and Park Water should the Commission adopt the WRAMs and MCBAs provided for in the pending settlement agreements with those companies. DRA also presented its witness, Tatiana Olea, who testified on how a reduction in ROE – if ordered by the Commission in this Phase 1B – could be implemented.

Given DRA's insistence on a reduction in authorized ROEs as a result of this "one-off" consideration of WRAMS and MCBAs – instead of a more proper consideration of these issues in a comprehensive cost-of-capital proceeding – the burden of proof clearly falls on DRA in this proceeding. CWA asserts that the evidentiary record clearly demonstrates that DRA has failed to meet this burden.

CWA and its member water utilities oppose any reduction in authorized ROEs related to the implementation of WRAMs and MCBAs. CWA asserts that WRAMs and MCBAs, at best, will reduce the water utilities' diversifiable risks, but will have no effect on the utilities' systematic, or market risk – the component of overall risk

on which investors rely to make investment decisions.³ Since the WRAMs/MCBAs will only impact diversifiable risks, they have no impact on cost of capital.

CWA and several individual water utilities presented a number of expert witnesses during the evidentiary hearings who testified as to why DRA's recommendations for an ROE reduction – either now in this proceeding or later in separate cost of capital proceedings – are not supported by fact, financial theory or public policy. They further demonstrated that any ROE reduction will ultimately injure water utilities and their customers by making it harder for the utilities to access capital markets at a time when their capital needs are critical.

California American Water's witness, Michael Vilbert, and Park Water's witness, Thomas Zepp, both analyzed the financial theory and basis advanced by DRA for its recommended ROE reduction and concluded that the authorities cited by DRA do not support an ROE reduction, either in general or in particular respect to Ms. Murray's recommended 50 to 100-basis point ROE reduction. Both Dr. Vilbert and Dr. Zepp concluded that financial theory shows that WRAMs likely will have no effect on a water utility's systematic risk – the portion of overall risk with which investors are concerned – and thus no impact on a water utility's cost of capital.

Cal Water's and Golden State's witness, Walter Hulse, undertook an analysis of the market reaction to developments affecting several natural gas utilities which recently became subject to sales decoupling mechanisms. Mr. Hulse concluded that the market reaction, as measured by share price performance of these natural gas

³ Total risk is comprised of two specific types of risk: systematic (or non-diversifiable) risk and unsystematic (or diversifiable) risk. Investors receive compensation in the form of expected return only for systematic, or non-diversifiable risk. Unlike systematic risk, diversifiable risk can be avoided by forming a portfolio with diverse investments. *See, infra*, Section II.A.1.

utilities, showed no significant change as a result of the adoption of sales decoupling mechanisms. CWA's witness, Susan D. Abbott, testified that the investment community in general and the major credit rating agencies in particular have not attributed any reduction in risk to California energy utilities which have had revenue adjustment mechanisms in place for as long as 25 years.

Other water utility witnesses, including Golden State's Michael George and Park Water's Leigh Jordan, testified about the plethora of challenges and risks currently faced by Class A water utilities – including regulatory risks from new, less detailed sales forecasting methodologies prescribed in the Commission's new General Rate Case Plan for Class A water utilities, and the risks inherent in obtaining and maintaining adequate and reliable supplies of drinking water that comply with increasingly-strict water quality regulations – and how the beneficial impacts, if any, from a WRAM are small and pale in comparison to these risks.

Messrs. George and Jordan, as well as Dr. Vilbert, also testified that it is inappropriate for the Commission to look at a single aspect of water utility regulation – a WRAM – and attempt to determine a specific basis-point impact on ROE of that single aspect, separate and apart from all other considerations that affect ROE determinations. They and other water utility witnesses testified that the appropriate forum for determining a utility's return on equity is the new comprehensive cost of capital proceedings for water utilities, provided for as part of the Commission's new General Rate Case Plan, where all of the risks relevant to an individual water utility's ROE can be examined as a whole.

C. CWA's Position: No ROE Adjustments; Defer Consideration, If Any, To Utility-Specific Cost of Capital Proceedings.

Cost of capital proceedings for the three multi-district Class A water utilities are scheduled to commence in less than four months. ROEs should be company-specific. There should not be a generic ROE reduction applicable to all water utilities for a single item of risk determined in isolation from all the other risks each particular water utility faces.

The Commission has never implemented a reduction in authorized ROEs for any of the electric or gas utilities it regulates in connection with the authorization of and use by those utilities of their energy revenue adjustment mechanisms, and there is no reason for the Commission to treat water utilities any differently should WRAMs be approved in this proceeding. In the Commission's December 2005 Water Action Plan – a plan that “identifies the policy objectives that will guide the [Commission] in regulating investor-owned water utilities and highlights the actions that the Commission anticipates or will consider taking in order to implement these objectives”⁴ – one of seven identified objectives is “Strengthen Water Conservation Programs to a Level Comparable to those of Energy Utilities.”⁵ Among the actions identified by the Commission to accomplish this objective are “Remove current financial disincentives to water conservation” and “Establish utility financial incentives for greater conservation.”⁶ While a WRAM may remove one financial disincentive to water conservation, an ROE reduction adds a financial penalty that clearly runs counter to the concept of establishing utility financial *incentives* for greater conservation.

⁴ “Water Action Plan”, California Public Utilities Commission, December 15, 2005, at 3.

⁵ *Id.*, at 4.

⁶ *Id.*, at 9-10.

For these reasons and others, all of which are discussed in detail below, CWA urges the Commission not to implement any level of ROE reduction directly related to the adoption of WRAMs and MCBAs for Cal Water, Golden State and Park Water, or for any other water utility for which WRAMs and MCBAs may be approved in the future. The determination of each Class A water utility's authorized return on equity should be undertaken in the new cost of capital proceedings where all of the risks facing a particular utility can be considered together and in an appropriate context.

II. ARGUMENT

A. DRA's Recommendation for an ROE Reduction Has No Basis In Financial Theory, Fact or Public Policy.

DRA's recommended reduction of authorized ROEs if WRAMs and MCBAs are adopted for Cal Water, Golden State and Park Water is not based on any established financial theory or factual evidence and is contrary to and inconsistent with the Commission's goals of strengthening water conservation programs to a level comparable to the energy industry. Thus, the Commission must reject DRA's recommended ROE reduction related to the adoption of WRAMs and MCBAs.

1. DRA's Recommended ROE Reduction Is Not Supported by Established Principles of Finance Theory.

DRA's proposed ROE reduction is based on its assumptions that a WRAM will reduce accounting earnings variability of water utilities, and that such a reduction will reduce the utilities' systematic risk and result in a lower cost of capital required by the utilities. However, DRA's proposal is contradicted by well-established theories of finance that reducing a utility's diversifiable risks, such as weather-related risk, does not affect a utility's cost of capital.

Park Water's witness, Dr. Thomas M. Zepp, testified that total risk is comprised of two specific types of risk: systematic (or non-diversifiable) risk and unsystematic (or diversifiable) risk.⁷ California American Water's witness, Dr. Michael Vilbert, testified that under finance principles known as portfolio theory, investors receive compensation in the form of expected return only for systematic, or non-diversifiable risk. They receive no return for bearing unsystematic, or diversifiable risk because diversifiable risk can be avoided by establishing a portfolio of diversified investments.⁸ A risk such as weather does not affect an investor's expectation of return because it can be offset by diversifying the investments (making it a diversifiable risk). Vilbert Direct Testimony/California American Water, Ex. 33, at 26:18 – 27:3. Systematic risks are risks that cannot be offset by diversifying investments. *Id.*, at 19:6-9.

The record shows that a WRAM is likely to have *no* effect on the utility's systematic risk. Instead, a WRAM will reduce the utility's diversifiable risks, such as weather-related risks, which will not affect the cost of capital. Vilbert Direct Testimony/California American Water, Ex. 33, at 26:16-20; Reporter's Transcript ("RT"), at 872:2-5 (Vilbert/California American Water). As Dr. Vilbert testified, "the kind of variation that I believe the WRAM will reduce is the kind of variation that is diversifiable," and as such it will have no effect on the company's cost of capital. RT, at 880:17-19 (Vilbert/California American Water). Investors can avoid weather-related risk by including water utilities in different parts of the country in their portfolio, or by

⁷ "Phase 1B Rebuttal Testimony of Thomas M. Zepp" ("Zepp Rebuttal Testimony"), on behalf of Park Water Company, November 13, 2007, Hearing Exhibit 26, at 4.

⁸ "Direct Testimony of Michael J. Vilbert" ("Vilbert Direct Testimony") on behalf of California American Water, October 19, 2007, Hearing Exhibit 33, at 19:11-13.

including utilities in general, or even companies in other industries – in the United States or worldwide – in their portfolio. Vilbert Direct Testimony/California American Water, Ex. 33, at 26:21-22. As such, weather-related risk is not part of the risks affecting the cost of capital even though it does affect a utility’s earnings. *Id.*, at 26:22 – 27:1.⁹ Dr. Vilbert testified:

“...weather does affect earnings, and that as an investor matters. You care about that a lot because if your earnings are bad because of a drought, the price of your stock is likely to go down.

“That is a risk, though, that if I earned or held a water portfolio or portfolio of stocks, some of which were water utilities in California, some of them water utilities in New Jersey or Pennsylvania or somewhere else, the chances of both those places having a drought at the same time are probably slim.

“And diversifiable risk, not only is something bad happening, it is also something good happening. So you would have in this particular situation something bad happening to your stock that you owned in California but perhaps something good happening to your stock that you owned in Pennsylvania. And the result is that you end up with the expected rate of return, which is your cost of capital.” RT, 882: 27 – 883: 16 (Vilbert/California American Water).

Thus, the adoption of the WRAM, while it might remove part of the company’s total risk and affect the likelihood that the company will earn its allowed rate of return, would *not* affect the company’s cost of capital.¹⁰

⁹ DRA’s witness, Ms. Murray, acknowledges that her fundamental disagreement with the position of the water utility witnesses concerns whether weather is, or is not, a diversifiable risk. Ms. Murray believes weather is a systematic, not a diversifiable risk. RT, 893:10-17 (Murray/DRA). However, Ms. Murray is a minority of one in this case, as all of the other witnesses in this proceeding agree with Dr. Vilbert that weather is a diversifiable risk, not a systematic risk that affects costs of capital. *See*, Zepp Rebuttal Testimony/Park Water, Ex. 26, at 4-5; RT, 1038:14-20 (Abbott/CWA).

¹⁰ Park Water’s witness, Dr. Zepp, concurs with Dr. Vilbert’s testimony regarding a WRAM impacting a water utility’s diversifiable risk, but not impacting a water utility’s systematic risk, and therefore that a WRAM will have no impact on a water utility’s cost of capital. *See*, Zepp Rebuttal Testimony/Park Water, Ex. 26, at 4-5.

DRA's witness, Ms. Murray, testifies that "the Commission should rely on the change in earnings volatility, as applied in the context of the Capital Asset Pricing Model ("CAPM"), to determine the magnitude of the appropriate ROE adjustment."¹¹ Ms. Murray then cites a 1970 paper by Beaver, Kettler and Scholes, "The Association Between Market and Accounting Determined Risk Measures", *Accounting Review* 45 (1970), pp.654-682 ("Beaver Article"), and a 1994 paper by John, John and Reisman, "Accounting Data and Asset Valuation: Theory", *Review of Quantitative Finance and Accounting* 4 (1994), pp.311-320 ("John Article"), as support for the DRA proposal. Murray Direct Testimony/DRA, Ex. 39, Technical Appendix, at 4. However, neither of these articles provides any support for the DRA proposal.

DRA's proposal relies on the incorrect assumption that changes in a firm's earnings variability cause commensurate changes in its systematic risk. Murray Direct Testimony/DRA, Ex. 39, at 15; RT, at 863:5-12 (Murray/DRA). The Beaver Article does not support the methodology proposed by DRA. Because the goal of that paper is *forecasting*, not establishing a *causal link* between accounting variables and systematic risk, it has limited value or relevance here.¹² All that is required for a good forecast is correlation between accounting variables and systematic risk. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 4. This is a crucial distinction, because in the absence of causality, it does not follow that a change in any of the accounting

¹¹ "Phase 1B Testimony of Terry L. Murray" ("Murray Direct Testimony"), on behalf of DRA, corrected October 22, 2007, Hearing Exhibit 39, at 10.

¹² See, "Rebuttal Testimony of Dr. Michael J. Vilbert" ("Vilbert Rebuttal Testimony") on behalf of California American Water, November 13, 2007, Hearing Exhibit 34, at 3-4. The article notes that because many companies do not have traded stock and therefore cannot rely upon market information to estimate the company's beta, its measure of systematic risk, these companies have a need for a reliable measure of systematic risk in order to make decisions for capital budgeting. As a substitute for market information, the Beaver Article hopes to use accounting information to develop a measure of the systematic risk of a firm that does not have traded stock.

variables correlated with systematic risk translates into a change in systematic risk. In other words, unless the causal relationship between systematic risk and earnings variability and other accounting variables under consideration can be determined, it cannot be established how the systematic risk would be affected by a change in earnings variability, if at all.¹³

The Beaver Article, on which DRA's witness, Ms. Murray, primarily relies, establishes only that earnings variability and systematic risk are correlated, *not causally related*. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 4:6-9. DRA suggests using the model in an application for which it was not intended, namely inferring the effect on systematic risk from a change in one of the accounting variables in the model. *Id.*, at 7. The original article does not consider this situation. Moreover, DRA does not provide an analysis of whether the Beaver Article model would still apply under this change in assumptions. *Id.*, at 8. As a result, DRA's proposed adjustment to the authorized ROE for regulated water utilities lacks support from the articles on which it relies, and without such support the Commission should not implement it.

DRA's proposal fails to make a distinction between *correlation* and *causation*. DRA witness Ms. Murray wrongly assumes that the WRAM reduces all risks by the same factor, whether they are systematic or diversifiable. When two events are correlated, it means that they tend to occur together. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 4. When two variables are positively

¹³ To develop this forecast of the systematic risk, the Beaver Article starts from the assumption that the systematic risk of the security (its beta) does not change over time. The purpose of their inquiry is to develop a good forecast of the future beta based on currently known variables, and they show that relying on several accounting measures, including the variability of earnings, outperforms the forecast based on the market beta estimated from historical stock return data. *See*, Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 3-4.

(or negatively) correlated it means that when one variable increases, the other variable will also tend to increase if positively correlated or decrease if negatively correlated.

Causation is present when one event causes another event to occur. Dr. Vilbert provides in his testimony the following example distinguishing between causation and correlation:

...water boils when sufficient heat has been applied. The water is caused to boil by heating it. On the other hand, in the past it was noted that the performance of the U.S. stock market was correlated with the length of women's skirts. The higher the skirt length, the higher the market would be in the future, but there was no causal relationship. In other words, shortening women's skirts would not cause the stock market to increase. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 4:16-20.

While it is possible that variation in accounting earnings has a more fundamental relationship to the systematic risk of a company, the Beaver Article recognizes that "the accounting risk measures reflect both the systematic and individualistic risk components."¹⁴ In this context, Ms. Murray's methodology *assumes* that the WRAM reduces all risks by the same factor, whether they are systematic or diversifiable. If this were true, then the relationship between earnings variability and systematic risk would not change when earnings variability is changed, and one could rely on the estimated relationship between the two measures before the change to make predictions about the effects of the change. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 4-5. However, DRA does not show that this is likely to be the case, and offers no justification for this assumption. In other words, the effect of the WRAM could be to reduce the variability in earnings that is related to diversifiable risk, which would have no effect on the systematic risk of the company. Vilbert Direct

¹⁴ Beaver Article, p. 659.

Testimony/California American Water, Ex. 33, at 18:24 – 20:14. It would, therefore, not warrant a reduction in the company’s authorized return on equity.

Similarly, the John Article referenced by DRA does not support the use of earnings volatility as a proxy for systematic risk. As that article states, “[t]his paper derives one set of sufficient conditions so that the market beta can be replaced by an accounting beta.”¹⁵ An accounting beta is a quantity computed analogously to the market beta, except it is based on earnings rather than stock returns. It is a measure proportional to the covariance between a firm’s earnings and the earnings of the market portfolio. Vilbert Rebuttal/California American Water, Ex. 34, at 5. Contrary to DRA’s faulty assumption, the relevant quantity is the covariance of earnings with market earnings, not the variance of earnings. Beta is a measure of the covariance of a company’s stock returns with the market scaled by the variance of the market returns. *Id.* The John Article does not provide support for the use of the variance of earnings as a proxy for a stock’s market beta. *Id.*, at 5-6 At best, it can be interpreted as supporting a measure of systematic risk based on the covariance of earnings with market earnings, but that is not the quantity recommended by DRA.

In addition, DRA appears to misapply the relationship between accounting variables and systematic risk advocated by the Beaver Article to predict the effect on beta of changing the firm’s earnings volatility (to imply a one-for-one change in beta). Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 6. The Beaver Article uses three accounting variables to forecast the systematic risk: earnings variability, payout ratio, and average asset growth.¹⁶ DRA contends that the WRAM would cause a

¹⁵ John Article, at 312.

¹⁶ Beaver Article, at 672.

reduction in earnings variability, yet ignores the other two variables. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 6. However, because the beta estimate developed in the Beaver Article is a linear combination of these three accounting variables and a constant term, a particular percentage change in one of them will not, in general, translate in an equal percentage change in beta. An appropriate implementation of their methodology would involve forecasting the effect of the WRAM on all accounting variables used in the prediction, and then using the estimated linear relationship between these variables and beta to compute the implied change in beta. However, this approach would then rely on the assumption that the structural relationship between earnings variability and the other accounting variables, and beta, remains unchanged after the introduction of the WRAM. *Id.* This is something that DRA's witness, Ms. Murray, makes no attempt to justify, and is not supported by any of the studies relied upon by DRA.

DRA's reliance on the Beaver Article to estimate systematic risk is improper and unprecedented. As Dr. Vilbert testified, both academics and practitioners rely on stock returns to estimate systematic risk, not on the accounting variables suggested by the Beaver Article. Vilbert Rebuttal Testimony/California American Water, Ex. 34, at 7. As such, it is quite possible that their results may not be able to be replicated using recent accounting data because the accounting information available for today's companies is vastly different from what was available in the 1950s and 1960s, when the data used in the Beaver Article was generated. *Id.* Similarly, other available information (e.g., analyst reports and management forecasts) have changed dramatically and research has shown that the amount and quality of non-accounting information impacts the

relationship between market prices and accounting information. Furthermore, certain relations that may have held at that time could very well not hold today, which may explain why their method is not in widespread use today. *Id.*

Neither the Beaver Article nor the John Article provides any support for DRA's ROE reduction proposal. Indeed, nothing in the record reveals any established financial principles that would support DRA's proposed ROE reduction.

2. Market Responses to Adoption of Revenue Adjustment Mechanisms for Natural Gas Utilities Indicate No Change in Overall Risks of the Utilities.

Just as well-established principles of finance provide no support for DRA's recommended ROE reduction, the empirical evidence in the record also contradicts DRA's contention that a WRAM/MCBA would lead to higher market valuations of the water utilities' shares, and thereby reduce the utilities' cost of capital. Cal Water's and Golden State's witness, Walter S. Hulse III, performed a review of the market reaction to implementation of similar decoupling mechanisms in the natural gas industry. Mr. Hulse's review and his testimony reveal that these mechanisms have a neutral effect on share prices, and do not reduce the utilities' implied cost of equity. Thus, it would be improper and unfair to reduce the utilities' authorized ROEs, based on the false and unproven assumption that a WRAM/MCBA will result in a decrease in the utilities' cost of equity.¹⁷

Mr. Hulse's study analyzed the market reaction to decoupling mechanisms that have been approved in the recent past in the natural gas utility sector. The gas utility

¹⁷ Ms. Murray's reply testimony does nothing to establish that the proposed decoupling mechanisms will *reduce* the utilities' cost of equity. "Phase 1B Reply Testimony of Terry L. Murray" ("Murray Reply Testimony") on behalf of DRA, November 13, 2007, Hearing Exhibit 40. *See, also*, RT, 879:10-16 (Vilbert/California American Water).

sector was selected because it provides a larger sample of data and the decoupling mechanisms in place in the gas utility sector serve the same purpose as the proposed mechanisms in this proceeding (to eliminate the disincentive to promote conservation by decoupling revenues from sales volume). In addition, the gas utility decoupling mechanisms have a similar effect on a utility's revenues, and they have been in place for several years.¹⁸ Because investors focus on the ultimate effect on revenues and earnings regardless of the particular product or service, whether it is natural gas or water, gas utilities provide the best examples for analysis, and 11 gas utilities were reviewed.¹⁹ Hulse Direct Testimony/Cal Water/Golden State, Ex. 45, at 6:2-6.²⁰

Share price performance was used as an indicator of the market's positive or negative reaction to the approval of the decoupling mechanisms. If viewed favorably, the share price was expected to rise, assuming all other factors remain constant. Conversely, if viewed negatively, the share price was expected to drop. Percentage changes in share prices were then compared to percentage changes in the price performance of a gas utility index over the same time period to eliminate general market movements and to isolate the effect of company specific events. The performance of the utilities' stock was evaluated one day, seven days and 90 days from the date of the

¹⁸ "Direct Testimony of Walter S. Hulse III" ("Hulse Direct Testimony") on behalf of Cal Water and Golden State, October 19, 2007, Hearing Exhibit 45, at 2:18-22, 5:4 – 6:6.

¹⁹ In her reply testimony, Ms. Murray acknowledges the lack of any meaningful water utility comparisons, but is critical of and suggests the Commission should ignore the analysis of gas utilities without providing any justifiable reasons to do so or providing any reasonable alternative or concrete way to assess market reaction or the utilities' ability to access capital markets. Murray Reply Testimony/DRA, Ex. 40, at 9:5-11:4, 18:9-13, 20:2 – 21:9.

²⁰ See, also, "Prepared Testimony of Michael George" ("George Direct Testimony") on behalf of Golden State, October 19, 2007, Hearing Exhibit 31, at 14:1-4, 14:16 – 15:5 ([because of the small number of publicly traded water utilities, arguably insufficient to support a meaningful conclusion], "the next best option would be to evaluate WRAM-like mechanisms adopted in the context of other regulated industries.")

approval of the decoupling mechanism (reference date). Hulse Direct Testimony/Cal Water/Golden State, Ex. 45, at 3:1-20.)

This analysis of the market reaction to approval of decoupling mechanisms showed *no* significant market reaction over the long-term or short-term as measured for the eleven gas utilities reviewed. Hulse Direct Testimony/Cal Water/Golden State, Ex. 45, at 6:8-17. Not surprisingly, for three other gas utilities for which decoupling mechanisms were considered outside of a rate case, there was either no reduction to authorized ROE or an initial reduction was subsequently overturned and/or not ordered. For another six of the eleven utilities reviewed, no adjustment to ROE was specified as a direct result of the implementation of those mechanisms. *Id.*, at 6:19-20.

Mr. Hulse attempted to isolate the effect of the implementation of the decoupling mechanism (versus other factors) on the market by also focusing on two gas utilities whose primary business operates under the decoupling mechanism – rather than those gas utilities that operate across multiple states with varying regulatory frameworks and/or where the utility operating under the mechanism is not the sole or primary driver of the company’s share price – New Jersey Resources Corp. (“NJR”) and South Jersey Industries, Inc. (“SJI”).²¹ Although these two companies operate in the same state and had exactly the same decoupling mechanism approved, the market reactions were not consistent. This suggests that approval of the decoupling mechanism was not a major

²¹ Ms. Murray is critical of Mr. Hulse’s attempt to account for and/or eliminate extraneous factors to try to isolate any impact of decoupling mechanisms on share price by further focusing on NJR and SJI. Murray Rebuttal Testimony/DRA, Ex. 40, at 10:14-11:4. Simply because every single variable could not be eliminated for all utilities reviewed, and despite comparisons to the gas index to help eliminate fluctuations due to other factors common to the industry as a whole, Ms. Murray instead suggests “it is more logical to *assume*” that analysts’ opinions reflect the broad market reaction rather than consider the analysis of the available market data itself. *Id.*, at 12:1-9 (emphasis added). Regardless of Ms. Murray’s assumptions, Mr. Hulse’s analysis reveals no significant market reaction to the announcement or approval of decoupling mechanisms.

driver, positively or negatively, of the companies' share prices. Also, despite implementation of the decoupling programs for these two utilities independent of a rate case, the governing commission did not reduce their respective ROEs nor did it reset their ROEs to the same level, thus recognizing that the decoupling mechanism is independent of the required ROE. Hulse Direct Testimony/Cal Water/Golden State, Ex. 45, at 8:21-9:21.

Mr. Hulse performed the same analysis of market response using the date of NJR's and SJI's public announcements at the time they filed their requests for a decoupling mechanism as the reference date (instead of the approval date), to see if the market anticipated the approval and had already priced in the impact, also revealed no long-term impact on share price performance. Hulse Direct Testimony/Cal Water/Golden State, Ex. 45, at 9:23-10:20.)²² In addition, although research analysts' reactions to these announcements were qualitatively favorable because decoupling mechanisms eliminate one of the factors causing earning volatility, their positive reaction did not translate quantitatively into a sustained increase in share price and thus, did not reduce the utilities' cost of equity. *Id.*, at 10:22 – 11:2. This is because decoupling mechanisms, at best, remove short-term, annual fluctuations in earnings volatility, without affecting long-term earnings power, and investors generally take a long-term view.

²² Ms. Murray implicitly acknowledges the propriety of Mr. Hulse's analysis of market reaction using the announcement date in addition to the approval date for the two most comparable gas utilities, but tries to downplay these results, which support the utilities' position, by complaining that the same analysis was not performed on all of the other nine utilities. Ms. Murray provides no evidence, however, that the results for the other nine utilities would be any different, much less that they would demonstrate that such an announcement reflects a reduction in the cost of equity. Murray Reply Testimony/DRA, Ex. 40, at 10, fn. 26. As Ms. Murray admits, market data certainly does not establish that decoupling mechanisms have a *positive* effect on share prices. *Id.*, at 20:15-17.)

Thus, although market analysts qualitatively view decoupling mechanisms positively, decoupling mechanisms do not translate into higher market valuations, as reflected by the absence of any measurable impact on share prices. Announcements of approved decoupling mechanisms appear to have a neutral effect on the market as well. Because markets do not give any material value to the approval of decoupling mechanisms, there does not appear to be a decrease in the cost of equity when the utility operates under such mechanisms. Therefore, from a cost of equity perspective, no reduction of a utility's ROE due to the implementation of a decoupling mechanism is warranted.

3. Credit Rating Agencies' Responses to the Adoption of Energy Revenue Adjustment Mechanisms for California Energy Utilities Indicate No Change in Overall Risks of the Utilities.

As further evidence that DRA's proposed ROE reduction lacks any factual predicates, CWA's witness, Ms. Susan Abbott, provided testimony on how the major credit rating agencies – Standard & Poor's, Moody's, *etc.* – have responded to the adoption of electric revenue adjustment mechanism ("RAMs") for California energy utilities and whether such utilities have been deemed by the rating agencies to have lower risk profiles due to the ERAMs. Ms. Abbot testifies that "the rating agencies do not weight [ERAMs] in California heavily in their rating deliberations," and that the overall business risk of the California energy utilities for which RAMs have been adopted "do not enjoy a lower business risk profile than energy utilities in jurisdictions where balancing accounts are absent or minimal."²³

²³ "Direct Testimony of Susan D. Abbott" ("Abbott Direct Testimony") on behalf of California Water Association, October 19, 2007, Hearing Exhibit 43, at 2.

Ms. Abbott testifies that “[r]ating agencies provide investors with information used to determine creditworthiness – in other words, whether and at what cost a company may borrow money.” Although the proposal in this proceeding relates to the cost of equity capital, not debt capital, and “[w]hile equity and debt holders have differing expectation and time horizons, they all benefit or suffer with the performance of the companies in which they’ve invested ... [and] they all look at the same issues, including level of risk relative to the stated potential return.” Abbot Direct Testimony/CWA, Ex. 43, at 7, 6.

With respect to the California energy utilities for which ERAMs have been adopted, Ms. Abbott testifies that:

“[a]ccording to S&P, Pacific Gas & Electric and Southern California Edison have business risks of “6” on a scale of “1” to “10”, best to worse. San Diego Gas & Electric has a business risk assessment of “5”. The average business risk in the category that all three companies are assessed (integrated electric, gas and combination utilities) is 5.43. The average business risk of integrated electric, gas combination utilities rated between A+ and BBB+ is 4.76. Obviously, the rating agencies aren’t giving much credit for the adjustment clauses used by California regulators. However, it is my opinion that without the adjustment clauses, business risk assessments might be higher given the history of regulation in California.” Abbott Direct Testimony/CWA, Ex. 43, at 3.²⁴

Rating agencies decide ratings based on two factors: financial strength and business risk. Ms. Abbott testifies that while the metrics used by S&P to assess financial strength on average “would, on the surface, make [CWA’s Class A water utility members] eligible for a single-A rating ... assuming their business risk is assessed at ‘3’,” several factors, including the relatively small size of the water utilities in relation to the energy utilities, and regulatory risk, lead to a high business risk for the water utility

²⁴ S&P rates PG&E, Southern California Edison and San Diego Gas & Electric all at BBB+. Abbott Direct Testimony/CWA, Ex. 43, at 3.

industry. Abbott Direct Testimony/CWA, Ex. 43, at 8. Many of these risks are discussed in detail below. Ms. Abbott concludes that:

“[t]he water utility industry is facing mounting challenges to its financial integrity from a variety of sources. Environmental requirements, aging infrastructure, the public necessity the industry fulfills, and the capital intensive nature of the industry are but a few of the challenges with which the water industry must cope. In many cases, water utilities’ challenges are greater than those of other regulated utilities like electric and gas companies. ... Therefore, a careful consideration of the potentially devastating consequences of the diminution in allowed returns on equity that is being proposed [by DRA] is critical. The overriding result of a reduced allowable return on equity is a reduction in cash flow that a company would otherwise be able to generate. During a time such as the present, when the industry’s challenges are growing rather than shrinking, a reduction in a company’s ability to generate cash flow is counterproductive. This point is especially compelling, given the fact that regulated investor-owned water companies are net negative cash-flow businesses in the first place.” Abbott Direct Testimony/CWA, Ex. 43, at 11.

Ms. Abbott’s testimony provides not only empirical evidence that the major credit rating agencies view ERAMs as having little impact on the business risk profiles of California energy utilities, but also evidence that a reduction in ROE related to the adoption of WRAMs/MCBAs for water utilities could have a devastating impact on their ability to meet the significant challenges currently confronting them.

4. DRA’s Recommended ROE Reduction Is Contrary to and Inconsistent with Commission Policy on Water Conservation.

As noted at the outset of this brief, the Commission’s Water Action Plan, adopted in December 2005, identifies specific objectives for the regulation of water utilities including the objective of strengthening water conservation programs to a level comparable to those of energy utilities. In order to do this, the Water Action Plan states that the Commission will “[r]emove current financial disincentives to water conservation” and “establish utility financial incentives for greater conservation.” Water

Action Plan, at 4-5. DRA's proposed ROE reduction is contrary to this fundamental building block of the Commission's clearly-stated water conservation policy.

Strengthening water conservation programs to a level comparable to those of energy utilities clearly implies that water utilities should be accorded similar treatment with the energy utilities on all aspects of conservation policy. As discussed in greater detail below, during the nearly three decades that ERAMs have been used in regulating energy utilities, the Commission has never instituted an ROE reduction for any energy utility, or for the energy industry generically, that is specifically attributable to a revenue adjustment mechanism. DRA has presented no evidence or articulated any policy reason why water utilities should be treated differently than energy utilities in this regard. An ROE reduction clearly constitutes a financial disincentive – a factor the Water Action Plan specifically proposes to remove – to water conservation. As Cal Water's witness, Stan Ferraro, testified:

“[a]dopting a return on equity (ROE) adjustment would have a definite chilling effect on a water utility manager's enthusiasm for water conservation ... [and] water conservation rates and other conservation programs. The Commission has experience with implementing a revenue adjustment mechanism and no ROE adjustment for energy utilities, which resulted in aggressive and successful energy conservation programs. By treating water utilities in a similar manner, the Commission should expect water utilities to deliver aggressive and successful water conservation programs.”²⁵

Moreover, the basis for DRA's proposal to reduce authorized ROEs in this proceeding appears to be at least somewhat punitive in nature, regardless of the impact of the WRAMs and MCBAs. When asked whether an ROE reduction would still be applicable if there were no variance whatsoever between the adopted and the actual sales

²⁵ “Prepared Testimony of Francis S. Ferraro” (“Ferraro Direct Testimony”) on behalf of Cal Water, Hearing Exhibit 29, at 1-2.

– and thus no dollars were overcollected or undercollected in the balancing account –

DRA’s witness, Ms. Olea, stated that:

“[DRA’s] recommendation would continue to be that the Commission adopt *a reduction in ROE because of the change in ratemaking which is the adoption of the WRAM and MCBA*. The end result ... being that there was no difference whatsoever between adopted and actual would not affect our recommendation. So in that case, we would still recommend the reduction [in ROE].” RT, 981:23 – 982:2 (Olea/DRA); emphasis added. Water utilities should not be penalized financially for the adoption of

WRAMs/MCBAs. To do so would be completely contrary to the Commission’s stated goals of removing financial disincentives for promoting water conservation and for strengthening water conservation programs to a level comparable to those of energy utilities. Instead, the water utilities look forward to discussing the establishment of utility financial incentives for greater conservation as stated in the Water Action Plan.

B. DRA’s Specific Recommendation for a 50 to 100-Basis Point ROE Reduction Also Has No Basis and Is Completely Arbitrary.

Like its general recommendation for a reduction in ROE, DRA’s specific recommendation for a 50 to 100-basis point reduction in authorized ROEs similarly lacks any factual or rational basis. The math employed by DRA simply does not add up, making the 50 to 100-basis point recommendation arbitrary and thus, legally insufficient of supporting an ROE reduction order.

DRA’s witness, Ms. Murray, starts her explanation of the 50 to 100-basis point recommendation by stating that the component of the authorized return on equity that compensates water utilities for bearing risks other than the time value of money and inflation can be calculated by subtracting the current yield on long-term Treasury bonds from an authorized return on equity. Using Cal Water’s latest authorized ROE of 10.16% as an example, Ms. Murray states that this ROE “implicitly grants Cal Water a 528-basis

point ‘risk premium’ over the 30-year Treasury bond yield ($10.16\% - 4.88\% = 5.28\%$) as compensation for bearing all risks other than the time-value of money and inflation.”²⁶

Ms. Murray then goes on to discuss that the combination of WRAMs and MCBAs will greatly reduce the earnings volatility of the water utilities and, after citing various financial analyst reports on the anticipated impact of the WRAMs/MCBAs in reducing earnings volatility for regulated California water utilities, testifies that:

“the DRA-Cal Water settlement easily could reduce the company’s earnings volatility attributable to regulated California water service by 50%. Thus, if the Commission were to calculate an ROE adjustment designed to restore the previous risk-reward balance for Cal Water, that adjustment would need to be an ROE reduction of at least 264 basis points (528 basis points multiplied by .50). The resulting ROE would be no greater than 7.52% ($10.16\% - 2.64\%$ or 264 basis points).” Murray Direct Testimony/DRA, Ex. 39, at 19-20.

Ms. Murray’s original calculation of the 528 basis points was a quantification of the “compensation for bearing *all risks* other than the time-value of money and inflation”. But by noting that WRAMs/MCBAs “could reduce the company’s earnings volatility ... by 50%”, and then applying that 50% to the entirety of the 528 basis points, Ms. Murray inexplicably and erroneously assumes that earnings volatility accounts for *all* of the 528-basis point differential between a 10.16% ROE and the 4.88% 30-year Treasury bond yield. This clearly cannot be the case in light of all of the other, much more significant risks faced by the water industry and described in greater detail below.

Regardless (and perhaps in light of) the suspect math and reasoning, Ms. Murray does not recommend a 264-basis point reduction in Cal Water’s existing ROE. Acknowledging that such a large reduction “could jeopardize the water utilities’ ability to

²⁶ “Phase 1B Testimony of Terry L. Murray” (“Murray Direct Testimony”) on behalf of DRA, corrected on October 22, 2007, Hearing Exhibit 39, at 11-12.

continue obtaining debt financing on favorable terms[,] ... significantly reduce debt coverage ratios, ... [and] increase the cost of new debt or even, in extreme cases, make it difficult for the utilities to obtain new debt financing at all,” Ms. Murray seemingly picks out of the air a recommended 50 to 100-basis point reduction. Murray Direct Testimony/DRA, Ex. 39, at 20. Under cross-examination, Ms. Murray confirmed her arbitrary recommendation. When asked if “there [was] any mathematical way to get from 264 to 50 to a hundred [basis points]”, she replied “Absolutely not.” RT, at 929:13-15 (Murray/DRA).²⁷

Ms. Murray’s math does not add up and cannot serve as the basis for the Commission to order a 50 to 100-basis point reduction in authorized ROEs. As demonstrated above in the discussion of past energy utility decisions, the Commission has never quantified any basis point amount attributable to the adoption of a revenue adjustment mechanism. Ms. Murray’s attempts to do so in this proceeding perhaps serve to illustrate why. As California American Water’s witness Dr. Vilbert testified, “[w]henver you estimate any parameter, you know that ... there’s an error involved in it of some sort. And... it[‘s] very difficult to try to tease out one small factor of many factors that affect the cost of capital from an estimated cost of capital using the standard models that we have.” RT, 878:18-27 (Vilbert/California American Water). Dr. Vilbert recommended that “you’re better off doing all of this in the context of a cost of capital hearing where you’re trying to set the cost of capital with a company based upon all of its risks together ...” RT, 881:16-21 (Vilbert/California American Water).

²⁷ Ms. Murray did testify that the 50-100 basis point amount “represents a combination of factors”, that include her erroneous assumption that “weather is ... a systematic risk that affects the economy as a whole”, and her “20 years of experience both at this Commission and in the regulatory world doing a lot of cost of capital ... [and] other proceedings.” RT, at 929: 16-26 (Murray/DRA). However, no mathematical basis is offered as justification for Ms. Murray’s recommended 50 to 100-basis point reduction.

Based on the record, DRA's 50 to 100-basis point recommendation has no factual or logical basis and should be rejected by the Commission.

C. Company-Specific ROE Determinations Should Be Made in the New Water Utility Cost of Capital Proceedings Where All Risk Factors Can Be Considered Together.

Returns on equity are company-specific determinations based on the circumstances unique to individual water utilities. Because there are many risks and factors to be considered in evaluating the proper ROE for any utility, it is inappropriate to isolate any single factor, such as the proposed WRAM, to make a generic adjustment to ROE for all utilities. The Commission should undertake an integrated review of all qualitative and quantitative factors related to each specific utility, the water industry as a whole, and capital market access. Thus, an adjustment to ROE should not be made solely on the basis of a theoretical risk reduction associated with adoption of the proposed WRAM being considered in this proceeding. Rather, ROEs should be determined in the comprehensive context of the new cost of capital proceedings adopted as part of the Commission's new General Rate Case plan for Class Water utilities. The three multi-district Class A water utilities – Cal Water, California American Water and Golden State – are scheduled to commence the first cost of capital proceedings on May 1, 2008. Those proceedings are likely to begin before a decision in this proceeding is issued.

The need to consider *all* of the risks and other factors that could affect a utility's ROE – as opposed to considering just one factor such as WRAMs/MCBAs – is a consistent theme addressed by many water utility witnesses in this proceeding. The water utility witnesses also described the many increasing and significant risks currently facing

the water industry, the totality of which dwarfs the reduction, if any, in risk provided by WRAMs/MCBAs. Some of these more significant impacts are discussed below.

1. Increases in Regulatory Risk.

Despite positive changes in the regulatory arena, such as the Commission's adoption of the Water Action Plan, water utilities face other changes in the regulatory arena that increase their regulatory risk. For example, under the new General Rate Case plan, instead of a two-year forecast of sales/revenue, utilities are now limited to a single-year forecast with inflation adjustments in the following two years. This single-year forecast exposes utilities to an intra-rate cycle discrepancy between the estimated rates of inflation used to adjust rates in the two attrition years and the rate of actual cost increases the utilities experience. George Direct Testimony/Golden State, Ex. 31, at 3:23 – 4:2. Thus, the utilities absorb more financial risk under the new rate case procedures for rising actual costs that exceed the rate of inflation (such as health care costs), yet there has been no proposed upward adjustment to ROE to offset this increasing risk. *Id.*, at 4:4 - 4:10.

Another unaccounted-for regulatory risk results from the new requirement that all utilities use a single, simplified forecast methodology. While this procedure provides certain valuable benefits as it streamlines the rate case process and reduces the burden on PUC staff, such simplification also reduces the potential accuracy of the forecast, and can result in discrepancies that can increase revenue and earnings fluctuation over shorter periods. George Direct Testimony/Golden State, at 4:11-17. As an example, within the context of promoting conservation, the simplified forecasting methodology ignores the impact on consumption resulting from conservation pricing

mechanisms, because the mandated methodology does not include a pricing variable. Most important, in the specific context of potential adjustment to ROE, this simplified methodology results in an increase in water utilities' operating risk or business risk compared to more flexible forecasting methodologies. *Id.*, at 4:19 - 26; *see, also*, RT, 831:28 – 832:9 (George/Golden State); RT, 730:6 - 732:8 (Jordan/Park Water).²⁸

2. Increases in Water Quality Risk.

Water utilities have experienced increases in their operating, financial, and business risks as a result of the increasingly stringent water quality regulations and product liability lawsuits. Amendments to the federal Safe Water Drinking Act and actions taken by the Environmental Protection Agency (“EPA”) have resulted in an increase of regulated constituents from roughly 25 original constituents to nearly 150 today. George Direct Testimony/Golden State, Ex. 31, at 5:17-21. As the number of constituents has increased and improvements in the ability to detect minute concentrations have been made, the related operating costs for the water companies have increased dramatically. Such costs include expenditures to test for various contaminants, to ensure that the water the utilities provide to their customers complies with water quality standards and regulations, and to respond in the rare instances when those levels are or are at risk of being exceeded. *Id.*, at 5:21-6:6. Further, utilities produce annual “water quality report cards” to inform customers of water constituents. The water utilities continue to develop detection and treatment systems to improve and to assure consistent drinking water quality. However, these systems and other steps the water

²⁸ In the “Testimony of Leigh K. Jordan” (“Jordan Direct Testimony”) on behalf of Park Water, November 17, 2006, Hearing Exhibit 22, at 3-7, Mr. Jordan also discusses a number of significant risks faced by the water utility industry that far outweigh any reduction in risk associated with WRAMs and MCBAs.

utilities must undertake to meet the increasingly stricter water quality standards also increase the operating and financial risks they face. *Id.*, 6:6-15.

While water has not been deemed a “product” for purposes of products liability lawsuits in California, plaintiffs armed with the water quality report cards continue their quest to establish causal connections between water constituents and long-term health impairment among utility customers with the objective of imposing liability on the water utilities. George Direct Testimony/Golden State, Ex. 31, at 6:17-28. Water utilities have, so far, been successful in defending strict tort liability actions brought by the plaintiff’s bar for supposed injuries allegedly caused by constituents in the water supplied by the utilities, but the costs of defense have been significant.²⁹ The utilities’ water quality report cards continue to provide fodder for enterprising attorneys to try to find potentially injured customers – or even a class of customers – and file additional lawsuits based on groundwater pollution. Water utilities will continue to face the substantial costs of defense of such actions (even if the defense is eventually successful on the merits) as well as the costs of managing the impact of constituent reports and lawsuits on customer confidence, satisfaction and relations. The threat of such liability is another increasing business risk the water utilities face. *Id.*, at 6:23 - 7:6.

3. Increases in Supply Availability Risk.

Water utilities in California also face an increased risk of supply availability amid both drought and regulatory shortages. While California’s investor-owned water utilities produce a substantial portion of the water they serve to customers

²⁹ Recognizing the inherent protection for customers, the Commission has allowed the water utilities to recover the costs of defense, and the Commission has consistently exercised exclusive jurisdiction (in cooperation with the Department of Health Services) over water quality standards, thus offering “safe harbor” protection from the epidemic of class action water quality lawsuits. George Direct Testimony/Golden State, Ex. 31, at 5:2-11.

from their own adjudicated groundwater production rights, the remaining supplies are purchased through intermediate wholesalers, primarily the Metropolitan Water District of Southern California (“MWD”).³⁰ George Direct Testimony/Golden State, at 7:8-22. Water utilities not only face shortages in wholesale supplies (discussed below), but also increasing costs and risks related to their native groundwater supplies. They undertake steps to avoid and resolve groundwater contamination issues and to protect native groundwater and storage assets, as well as other efforts to increase quality and reliability while managing for continued affordability of local water resources. Again, these efforts increase water supply costs and cannot guarantee successful resolution of every threat to groundwater supplies. *Id.*, 7:24 - 8:2.

Water utilities also face increasing supply availability risk in connection with their wholesale supply arrangements. George Direct Testimony, Ex. 31, at 8:4-9. For example, recently negotiated reductions in the amount of water available to Los Angeles from the Owens Valley reduced supplies and reserves available to other MWD customers, including some of CWA’s members, because Los Angeles taps MWD to make up for reductions in supplies available from the Owens Valley. *Id.*, at 8:11-25. To compound the risk associated with strained water supplies, MWD has also faced a reduction in the amount of water it can obtain from the Colorado River, based on the current effects of long-term drought and constraints within the Colorado River Compact. *Id.*, at 9:1 – 23. Finally, MWD has been forced to rely more heavily on State Water Project (“SWP”) supplies, but the SWP faces substantial pumping restrictions, imposed by a recent court order, to meet environmental restoration and endangered species

³⁰ For example, Golden State produces roughly 45% of customer deliveries from its own water rights, while purchasing the remainder of customer deliveries primarily through MWD. George Direct Testimony/Golden State, Ex. 31, at 7:15-18.

protection objectives.³¹ *Id.*, at 9:25 - 10:21. Utilities, their customers and their investors have learned to deal with unpredictable impacts of weather and recurrent drought cycles. However, these emerging wholesale supply risks, coupled with the long-term risks to the water supply system associated with climate change, impose new and increasing business risk on water utilities, particularly those with a substantial portion of their customer base in Southern California. *Id.*, at 10: 23 - 28.

The water utilities have been addressing these threats to water supplies by devoting substantial resources to water supply management, maintenance and augmentation. This includes investigating mutual aid arrangements with MWD and others, developing rates and programs to encourage increased conservation, improving management of local water supplies, campaigning for institutional arrangements to support flexibility of local resources, investigating and implementing cost-efficient methods to address environmental concerns, and supporting improvements in conveyance systems. George Direct Testimony/Golden State, Ex. 31, at 11:1 - 15. Despite the utilities' efforts to help mitigate the increasing risks in water supply availability, the water supply risks are increasing and will continue to increase because the basic resource is under pressure from growth, competition, climate and pollution. As with the other emerging or increasing business risks faced by the utilities, water utility ROEs have not

³¹ DRA's witness, Ms. Murray, explicitly acknowledged that water companies are facing increasing water supply issues. RT, 963:44-8 (Murray/DRA). DRA does not provide any evidence or testimony to dispute the numerous increasing risks that water utilities are facing, but only that they "belong in a general cost-of-capital proceeding and do not fall within the scope of this proceeding as [Ms. Murray] understand[s] it." Murray Reply Testimony/DRA, Ex. 40, at 13:1-8. In fact, Ms. Murray acknowledges that consideration of cost of capital issues in a comprehensive proceeding would result in "benefits of greater accuracy and a more precise reflection of risks [,]" but assumes for all that it would be unduly burdensome to the regulatory process and all parties concerned. *Id.* at 14:17 - 15:2.

been adjusted upwards to offset these new threats to the utilities' underlying supply sources. *Id.*, at 11:17 - 20.

In light of the multitude of *increasing* risks water utilities face, for which no upward ROE adjustment has been made, imposing a downward adjustment to ROE based solely on a theoretical risk benefit associated with a WRAM/MCBA decoupling mechanism is not only unsupported as a factual matter, but patently unfair. George Direct Testimony/Golden State, Ex. 31, at 11:27 – 12:10, 12:22-27, 13:1 – 20. Rather, fairness and an enlightened regulatory policy suggest that any adjustment to or setting of ROE should be done in a comprehensive proceeding, such as the cost of capital proceeding set to begin in May 2008, rather than on a piecemeal basis. In the comprehensive ROE setting, the Commission can take into account all relevant company-specific, industry-specific, and capital market conditions necessary to a fair determination of allowable ROE. *Id.*, at 13:18-20, 15:7-12; RT, 764:17-26 (Jordan/Park Water); RT, 845:7-8:14 (George/Golden State); RT, 881:15-882:28 (Vilbert/California American Water. Even DRA's witness, Ms. Murray, testified that in considering cost of capital, the Commission "is obligated every time it looks at cost of capital broadly to look at all of [the risk factors pro and con]." RT, 931:21-26 (Murray/DRA).

D. The Commission Has Never Reduced Any Utility's Authorized Return On Equity Solely Based on Implementation of a Revenue Adjustment Mechanism, and It Should Not Do So Here.

DRA's recommendation for an immediate 50 to 100-basis point direct reduction in the existing, authorized ROEs for Cal Water, Golden State and Park Water if WRAMs and MCBAs are adopted for those companies has absolutely no precedent before this Commission or any other state regulatory commissions that have adopted

sales decoupling mechanisms for electric or gas utilities.³² The Commission first authorized the use of sales decoupling mechanisms for gas and electric utilities in the late 1970s and early 1980s, but contrary to what DRA's testimony implies, the Commission has never reduced an existing, authorized return on equity of any energy utility solely as a result of authorizing a RAM for a utility. There is no reason for the Commission to do so now.

DRA's witness, Ms. Murray, testified that "the Commission [has] repeatedly cited the reduction in risk attributable to the revenue adjustment mechanisms as justification for adopting a lower ROE than the energy utilities had requested." Murray Reply Testimony/DRA, Ex. 40, at 22. However, under cross-examination, Ms. Murray admitted that the cases she cited in support of her testimony on that point were general rate cases – not generic investigations like this proceeding – and that any reductions were reductions to ROEs that the utilities had *requested* in their GRC applications. RT, 935:26 – 936:23; and 937:11 – 938:14 (Murray/DRA). Ms. Murray also confirmed that the Commission has never reduced an existing, authorized ROE for a utility due to the adoption of a RAM (RT, 938:16 – 24)³³ and that "the Commission has never explicitly quantified an adjustment [to ROE attributable solely to the adoption of a

³² See, "Testimony of Thomas M. Zepp" ("Zepp Direct Testimony") on behalf of Park Water Company, November 17, 2006, Hearing Exhibit 25, at 3. Dr. Zepp testifies that "[o]ther [state utility] commissions have agreed with California and have not reduced ROEs when they implemented RAMs", citing actions taken by the state utility commissions in Washington, Maine and Oregon.

³³ Ms. Murray did cite D.91-10-042 (1991 Cal. PUC LEXIS 697), a decision in the Commission's Drought OII for water (Murray Rebuttal, Ex. 40, at 17) as an example of where existing authorized ROEs were reduced due to the authorization of drought memorandum accounts (not RAMs) to track lost sales due to rationing during the drought of the early 1990s. But that example is easily distinguishable from this proceeding. In the drought of the early 1990s, the Commission was *reacting* to several situations (the drought and mandatory rationing imposed by water suppliers, among others) that were of unknown duration which could have lasted for only another month, or for many years. As Cal Water's witness, Stan Ferraro, testified, "I don't see those events really mirroring what we have here today. The conditions [then] were pretty dramatic. And the first time the Commission really addressed this issue was for drought, not for ongoing conservation." RT, 818:3-15 (Ferraro/Cal Water). Here, the Commission is implementing proactive water conservation policy that is likely to be permanent in nature.

RAM]. They have explicitly considered the revenue adjustment mechanisms, but they have not explicitly stated how many basis points an adjustment for that would have been.” RT, 935:15-24.³⁴

To be sure, a survey of Commission decisions from general rate cases (“GRCs”) in the late 1970s and early 1980s in which RAMs were authorized for electric utilities and gas utilities makes clear that any reduction in risk resulting from the adoption of a RAM is just one of many considerations that must be analyzed in determining a utility’s ROE. These decisions also confirm that ROEs were set for the energy utilities with RAMs in general rate case proceedings specific to the individual utility, not in broad generic proceedings such as this water conservation investigation.

The first relevant decision was the Commission’s 1978 order establishing a supply adjustment mechanism (“SAM”) to provide natural gas utilities the opportunity to recover the test year level of gas margin in a period of skyrocketing energy costs and scarcity of fossil fuels. *See*, D.88835, 1978 Cal. PUC Lexis 62; 84 CPUC 5, adopted May 16, 1978. In that decision, the Commission recognized a linkage between a SAM and the previously adopted inverted block rate structure, which had substantially *increased* gas utilities’ business risk. The Commission viewed the SAM as “a logical concomitant of our policy of inverted rates,” recognizing that:

“supply (or more correctly, sales) volume has become at once (1) a factor of extraordinary impact on the gas margin as well as (2) an element of ratemaking that cannot be quantitatively predicted with the precision required to assure that a utility neither grossly exceeds nor falls far short of its authorized gas margin. In short,

³⁴ *See, also*, “DRA’s Response to California Water Association Data Request No. 1”, November 15, 2007, Hearing Exhibit 38, at 3. In response to CWA’s Request 2(b), DRA replied that it “agrees that the Commission did not make an explicitly quantified adjustment [for energy utility RAMs]; however, DRA disagrees with the proposition that the CPUC did not take the change in risk into account when it adopted ROEs for energy utilities post-ERAM.”

like the purchased *cost* of gas, supply fluctuation must be accorded special treatment between general rate proceedings.”

1978 Cal. PUC Lexis 62, at *12 (emphasis in original).

The Commission expressly rejected the argument that “adoption of a SAM will constitute a step in the direction of a guaranteed rate of return,” observing instead that:

“a SAM will merely insure that gas utilities achieve the gas margin last found necessary and *limit* the utility to that margin. Utility expenses *other* than the purchased cost of gas can and will change between general rate proceedings and those changes will determine whether the gas margin maintained by a SAM will actually produce a rate of return that meets or exceeds the utility's authorized rate of return. . . . A SAM will thus not guarantee a rate of return but only insure that a utility's exceeding or failing to meet that return will not be the result of extraordinary and unpredictable fluctuations in sales or supply.”

Id. at *13-14 (emphasis in original).

In approving implementation of a SAM for California’s gas utilities, the Commission recognized that adopting a SAM would reduce risk to the utility shareholder, but the Commission made no attempt to quantify that reduction. Instead, the Commission deferred the issue as one to be considered “in setting a reasonable rate of return in future general rate proceedings as well as those currently pending before the Commission.” *Id.* at *14.

In that next round of GRCs, the Commission kept the authorization of SAMs in mind, but still did not assign any specific value to them. In *Pacific Gas and Electric Co.*, D.89316, 1978 Cal. PUC Lexis 973; 84 CPUC 248, adopted September 6, 1978, the Commission stated,

“In determining a fair return on common equity for these proceedings, we have considered the impact on risk derived from our adoption of Rate Stabilization and Energy Cost Adjustment

Clause (ECAC) procedures for PG&E's electric department and the SAM and Purchased Gas Cost Adjustment Clause (PGA) for the gas department. We have also considered the fact that the Regulatory Lag Plan (applied to PG&E for the first time in these proceedings) worked extremely well.

“These measures are designed to better allow PG&E to maintain a reasonably constant cash flow between general rate proceedings. These measures, however, must be viewed in the context of recent increases in inflation and upward trends in interest rates. But for these measures, it is likely that a higher return on common equity might be warranted to insure the financial health of the utility. Although, as mentioned, our innovative ratemaking measures impact risk downward, we do not find that in the balance (weighed against rising debt cost) a reduction in allowed return on equity is warranted.”

Id. at *27-28. Accordingly, the Commission maintained PG&E’s authorized ROE at 12.83%.

In its first review of rates for Southwest Gas Co. (a company comparable in size to several Class A water utilities) following allowance of a SAM, the Commission noted staff’s recommendation that ROE be reduced from 13.3% to 12.97%, based on several considerations including the allowance of a SAM. *Southwest Gas Co.*, D.89706, 1978 Cal. PUC Lexis 1510, at *10, 84 CPUC 634, adopted December 12, 1978. Having “carefully considered all of the above-listed factors (including the effect of SAM),” the Commission concluded that the last authorized return on equity of 13.3% should be maintained. The Commission explained this determination as follows:

Our adoption of a 13.3 percent return on equity is made in recognition that, as the staff points out, there are factors since we originally adopted that return (in SW's last rate proceeding) which very arguably reduce risk. However, we stress, on the other hand, that the 13.3 percent rate on equity authorized herein is made with recognition that the next test year we will use to set rates for SW will be 1981. . . . Accordingly, we are authorizing the rates herein (through adoption of results of operation and return on equity rate base) conditional upon employing 1981 as the next earliest test year for establishing SW's base rates (and issuing a rate decision

prior to the beginning of such test year).

. . . Although SAM does not guarantee a gas utility will realize its authorized rate of return, it minimizes the impact of the most volatile contingencies facing a gas utility, gas supply available for sale, and less use per customer due to conservation efforts.

The factors that may operate between general rate proceedings in such a manner as to preclude SW's realizing its authorized return on equity are expenditures subject to its management's review and discretion. The innovative ratemaking procedures we have adopted, and continue to explore, have clearly paved the way to going a minimum of two years between general rate increases.

Id. at *12-14; *see also*, *Southern California Gas Co.*, D.89710, 1978 Cal. PUC Lexis 1506, *38-40; 84 CPUC 657, adopted December 12, 1978 (granting a 13.49% ROE with similar language). Thus, the Commission took the allowance of a SAM into account along with the effect of a two-year GRC cycle, and concluded that ROEs should be maintained or increased.

This string of gas utility decisions implementing the SAM and setting ROEs in the context of the SAM among other factors has clear implications for water utilities. If a two-year GRC cycle for Southwest Gas and SoCal Gas cancelled out the risk mitigation of a SAM, then the ever more rigorous three-year GRC cycle to which Class A water utilities are subject may justify the same response to the WRAM. More generally, it is clear that imposing a quantified, “explicit” ROE reduction based on the allowance of a WRAM, but without comparable ROE increases based on countervailing factors, including the implementation of tiered conservation rate designs and conservation hardware installation programs, would be unjustified and contrary to relevant Commission precedent.

The next round of energy utility GRCs featured the Commission’s approval of a similar revenue adjustment mechanism for electric rates, called the Electric

Revenue Adjustment Mechanism (“ERAM”). As will be evident, these cases provide no better support for the explicit ROE reduction recommended by DRA.

The Commission explained the value of the ERAM in a PG&E decision:

It will reduce the time devoted to the issue of appropriate sales estimate levels to be used for ratemaking. It is especially difficult in this period to make accurate sales estimates because of the state of the economy and the inability to accurately quantify the effects of conservation which we are expecting our utilities to promote even more vigorously in the future. Furthermore, the adoption of an ERAM at this time will eliminate any disincentives PG&E may have to promote vigorous conservation measures and also be fair to ratepayers in assuring that PG&E receives no more or no less than the level of revenues intended to be earned.

Pacific Gas and Electric Co., D.93887, 1981 Cal. PUC Lexis 1279, *86, 7 CPUC2d 349, adopted December 30, 1981. In the same decision, the Commission granted PG&E its highest ever ROE of 16.0%, based on a number of financial considerations, while observing – without any quantification – that “additional cash flow resulting from the Tax Act as well as the revenue stability from the Energy Revenue Adjustment Mechanism (ERAM) adopted herein should reduce PG&E's risk and thus the size of the return.” *Id.* at *14.³⁵

In a decision issued the same day, approving an ERAM for SDG&E, the Commission addressed the risk implications as follows:

Related to the question of risk reduction for the utility, we note that this decision provides for a revenue adjustment mechanism which protects SDG&E from any reduction in electric sales below the adopted figures. Conversely, if sales are above the adopted figures, the ratepayers will receive a refund. This mechanism is described in the results of operations section. We might mention there is a

³⁵ Elsewhere in the decision, the Commission observed that “the Tax Act has legislatively provided PG&E with a substantial increase in cash flow. Our adopted rate of return on rate base and return on common equity gives consideration to this increase in cash flow as well as the adoption of ERAM and attrition adjustment procedures.” *Id.* at *82. Thus, the Commission considered PG&E’s cash flow benefits under the Tax Reform Act of 1981 along with ERAM and a new attrition allowance, and still **increased** PG&E’s ROE to a level never seen before or since that date.

similar mechanism already in place for gas sales and this has insulated SDG&E from the effects of reduction in gas sales.

San Diego Gas & Electric Co., D.93892, 1981 Cal. PUC Lexis 1284; 7 CPUC2d 584, adopted December 30, 1981.

In the SDG&E decision, the Commission did not try to quantify the risk reduction benefits of SAM and ERAM. Rather, the Commission's attention was directed to the viability of SDG&E as an investment choice. The Commission observed that "since all utilities have to compete in the same marketplace as industrials, the rates of return must adequately reflect market conditions." Accordingly, the Commission adopted a historically high 16.25% return on common equity as reasonable for SDG&E. *Id.* at *39-40.

Finally, in *Southern California Edison Co.*, D.82-12-055, 1982 Cal. PUC LEXIS 1209, 10 CPUC2d 155, adopted December 13, 1982, the Commission noted several parties' opposition to the ERAM concept on the basis that it would detract from conservation efforts and shift a stockholder's risk to the ratepayers, but expressed the opinion that "any such effects are more than offset by the advantages that accrue to the ratepayer and stockholder alike." *Id.* at *30-31.

In addressing ROE in this Edison case, the Commission expressed the following considerations:

"The determination of a reasonable return on equity is necessarily a matter of judgment and cannot be reduced to a fixed formula. Each case must be decided after considering many variables, such as the cost of money, the capital structure of the utility in comparison with similar utilities, and interest coverage ratios. In addition, risk factors specific to the utility must be considered. We have provided for an electric revenue adjustment mechanism. This mechanism reduces the risk to the company that its earnings may be eroded by a reduction in electric sales below the adopted sales levels. We have also provided an attrition allowance which will

provide Edison a reasonable opportunity to earn the authorized rate of return in attrition year 1984.

“We take cognizance of the decline in interest rates which has occurred since the submission of this proceeding. There is now little indication that interest rates will approach levels during 1983 which were forecasted during the hearing process. In light of this factor, Edison's cost of financing should be lower than Edison originally anticipated.

“After weighing all of the above factors, we find that a return on common equity of 16% is just and reasonable.”

Id. at *233-34. In other words, having approved an ERAM and an attrition allowance for Edison and observing a decline in interest rates, the Commission still granted Edison a 16.0% ROE, the highest ever authorized for that utility.

These decisions illustrate that the Commission has consistently declined to quantify the basis point impact of a RAM on an electric utility's or a gas utility's ROE. It has never attempted to calculate the basis point value of every advantage or every disadvantage to which a utility is subject and then net those values out to determine an ROE. Instead, hewing to the principle that “the determination of a reasonable return on equity is necessarily a matter of judgment and cannot be reduced to a fixed formula”, the Commission has consistently considered the whole range of risks and other circumstances faced by utilities in order to determine a reasonable return on equity for each individual utility. No rational or compelling reason has been offered in this proceeding that would justify the Commission deviating from that practice. Thus, the Commission should reject DRA's recommendation for an immediate 50 to 100-basis point reduction in the existing ROEs of Cal Water, Golden State and Park Water should WRAMs and MCBAs be approved for those companies.

E. WRAMs and MCBAs Represent A Balanced Regulatory Mechanism That Provides Benefits to Ratepayers and Facilitates the Public Policy Goal of Water Conservation.

Despite DRA's attempts to describe WRAMs and MCBAs as mechanisms that "shift[] sales and revenue risk from shareholders to ratepayers ... [requiring] that ratepayers be compensated for accepting this risk via a reduction in the utility's ROE"³⁶, WRAMs and MCBAs actually represent balanced regulatory mechanisms that benefit utilities, ratepayers and the public in general. These mechanisms represent win-win-win regulatory mechanisms that do not result in anyone getting "hurt".³⁷

While WRAMs and MCBAs provide some short-term assurance that water utilities will earn a greater percentage of their *estimated* fixed costs, there is no assurance that *actual* fixed costs – which may differ dramatically from the costs *estimated* for a test year and then escalated by inflation for years two and three of the GRC cycle – will be recovered. The institution of water conservation programs and rate designs constitutes a completely new – and significant – risk: the risk of not selling enough water to cover *estimated* fixed costs. WRAMs and MCBAs are merely designed to address the new risks imposed from the institution of water conservation programs and rate designs. At the end of the day, water utilities will be left no better or worse off than they were prior to the institution of new water conservation programs and rate designs.

Ratepayers also benefit from the WRAMs/MCBAs in that the balancing account aspect of the WRAMs assures them of not paying more for water service than the water utilities' estimated costs of providing such service. Should a water utility sell more

³⁶ Murray Rebuttal Testimony/DRA, Ex. 40, at 3.

³⁷ In cross-examination, DRA's witness, Ms. Murray testified that WRAMs/MCBAs change "the balance of risk and reward and [if] you don't change the ROE, [the ratepayer] has gotten hurt." RT, 931:4-9 (Murray/DRA). CWA disagrees that anyone, balancing all of the circumstances, gets hurt by implementation of WRAMs/MCBAs.

water than is estimated for a particular period and the utility “earn more” than its authorized rate of return, the MCBAs will return that excess amount to ratepayers. As CWA’s witness, Ms. Abbott, testified:

“[RAMs] indeed assist in tempering volatility in revenues. However, they limit upside potential as well as downside risk. More important, they are regarded by the financial community as tools to bring revenue fluctuations caused by other factors into a tolerable range, not as a risk mitigation mechanism.” Abbott Direct Testimony/CWA, Ex. 43, at 13.

Finally, the public in general benefits from WRAMs and MCBAs due to the ability of California investor-owned water stakeholders to aggressively promote water conservation with limited downside risk to either water customers or water utilities.

Indeed, contrary to DRA’s recommendation that an ROE reduction is the necessary response to the implementation of WRAMs and MCBAs, a valid argument can be made in support of an increase if any adjustment to authorized ROEs is determined to be necessary. In an equitable regulatory system, the regulated company can expect to earn its authorized return, on average, over the long term. If it consistently fails to earn its authorized return, the regulatory system is asymmetric and unfair. If a WRAM were to make that asymmetry worse, then the appropriate response to adoption of a WRAM would be to *increase* – not decrease – the authorized ROE in order to provide the utility an opportunity to earn its cost of capital. Vilbert Direct Testimony/California American Water, Ex. 33, at 31:23-27.

The record shows that the adoption of a WRAM is likely to increase asymmetric risk given that the ability to sell more than forecast is a common way for regulated water utilities to earn or exceed the authorized return if actual costs exceed estimated costs. The WRAMs and MCBAs prevent that from happening. As a result, the

implementation of a WRAM could warrant an increase in the authorized return in order for the company to again expect to be able earn its cost of capital *on average*. For example, if a utility's costs consistently turn out to be above the forecast values used in the ratemaking process, the company would need to sell more than forecast to recover its actual costs. If the possibility of recovering more than forecast fixed costs is eliminated by the WRAMs/MCBAs, then as long as underestimation persists, the only way for the company to earn its cost of capital would be if the authorized return were increased sufficiently so that the return actually expected to be earned would be equal to the cost of capital. Preferably, the systematic underestimation of costs should be eliminated.

Under a fair and equitable regulatory system, the company should expect to earn its authorized return on average – sometimes more and sometimes less. In those circumstances, setting the authorized return equal to the cost of capital results in the company earning its cost of capital on average. On the other hand, if the company consistently fails to earn its authorized rate of return on equity due to some aspect of the regulatory system, then the authorized return must be set to a value sufficiently high so that the company can again expect to earn its cost of capital on average. To the extent that water utilities rely on selling more water than forecasted to earn their authorized cost of capital, implementation of a WRAM would increase the asymmetry inherent in the regulatory system and require an increase in the authorized return. Vilbert Direct Testimony/California American Water, Ex. 33, at 18.

The Commission must set rates to avoid the adverse effects to water utilities and their customers of falling short of the utility's cost of capital and inadequate returns, which lead to inadequate investment. In the long run, inadequate returns are

likely to cost customers – and society generally – far more than what may be gained in the short run, particularly given the capital-intensive water industry. Vilbert Direct Testimony/California American Water, Ex. 33, at 14.

F. DRA’s Recommendation of an ROE Adjustment Will Adversely Affect the Water Utilities’ Access to Capital at a Time When Capital Is Critically Needed.

Many of the new and significant risks currently faced by water utilities have been discussed earlier in this brief. These new and significant risks will require substantial capital investments in infrastructure. No party disputes that this is the case. CWA’s witness, Ms. Abbott, describes the current situation as an “extraordinary period in history, when water utilities face serious challenges to their financial integrity, including high levels of capital expenditures, a crucial need to promote conservation, and high levels of awareness of product quality.” Abbott Direct Testimony/CWA, Ex. 43, at 13. Ms. Abbott added that:

“Because the [water] industry faces a protracted period of capital spending in order to provide a safe, reliable service for its customers, access to capital at reasonable rates and in good and bad market conditions is an urgent matter. Any attempt to maintain or improve credit quality by introducing a WRAM would be adversely affected by a diminution in allowed returns on equity. Such an action would be sorely misguided, and would negatively impact the water utilities’ ability to attract capital at reasonable rates and on a when needed basis.” *Id.*, at 2.

Ms. Abbott also testified that one of the biggest risk faced by water utilities is the regulatory risk. Abbot Direct testimony/CWA, Ex. 43, at 10. Acknowledging this testimony, Commissioner Bohn asked Ms. Abbott to account for the difference between that testimony and what Commissioner Bohn “hear[s] from the street and from investors and the utilities all the time that California utilities as a group are less risky than utilities in general.” RT, 1076:8-17. Ms Abbott responded that:

“I think that it’s a matter of perspective.

“If I’m an investor and I’m looking at California today and I’m saying, okay ... the California environment today is rational, reasonable and ... is an environment where the interests of the shareholder and the interests of the ratepayer are recognized as being equal.

“That’s not always been the case here [in California], and I think that that history colors the opinion of a lot of investors and of the rating agencies.

“ ...

“California is not what California used to be, and that’s a good thing in the minds of many, but rating agencies and many fixed-income investors who really got hurt at certain points in history through investments in California have eloquent memories ...” RT, 1076:23 – 1077:17 (Abbott/CWA).

Echoing and expanding upon the impact of regulation on the water utilities, Golden State’s witness, Mr. George, testified:

“... [qualitative risks and business risks facing water utilities] ought to be considered together in a proceeding where all the various factors can be evaluated fairly and on a unified basis, because ... it is impossible to break out one or another. It’s like focusing on one brick rather than the wall. And therefore, my sense is that it is difficult for a utility to look at one factor broken out among all of the factors that affect our appropriate return on equity.

“And it is similarly difficult for the market to evaluate piecemeal changes in return on equity. It’s not just the issue of a specific tweaking of the return based on one factor. It is the risk that we as utilities and the market as arbiter of the value of our securities will look at the dysfunction of that process as impacting us and our equities over time.

“That is, to the extent that a factor is pulled out and said this is going to result in a reduction of ROE, you don’t just have the impact of that factor on the market at that moment. You also have the increased risk associated with the uncertainty in regulation because another one may be pulled out [in] the future and another one at another time.” RT, 845:12 – 846:6 (George/Golden State).

The Commission has taken an important and historic step in determining that water conservation must be pursued in California and that the financial disincentives

that affect the pursuit of that goal must be removed. At this crucial time when the California water industry faces the critical need for substantial capital investment, the Commission should not compromise the water utilities' ability to access the capital markets by arbitrarily reducing their ROEs and their resulting ability to generate cash flow. Setting allowed ROEs too low risks underinvestment that is likely to cost water utility customers far more than setting ROEs at a level that will permit them to attract sufficient capital investment.

III. CONCLUSION

Based on the record evidence and for all of the reasons described above, California Water Association urges the Commission not to order a reduction of any amount to the existing, authorized returns on equity for Cal Water, Golden State, or Park Water – or any other water utility – as a result of adopting WRAMs and MCBAs. The impact, if any, of these regulatory mechanisms should be considered along with all of the risks and other factors specific to each individual water utility in the new cost of capital proceedings that have been incorporated into the new General Rate Case plan for Class A water utilities. Having wisely decided to pursue water conservation in California and to remove any financial disincentives on the part of the water utilities to do so, the

Commission must not take a step backwards by imposing an unfounded, stand-alone, generic and ill-advised reduction to existing, authorized returns on equity.

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Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Jeannie Wong, hereby certify that on this date I will serve by electronic mail or hand delivery the foregoing OPENING BRIEF – PHASE 1B – OF CALIFORNIA WATER ASSOCIATION, on all parties on the attached CPUC service list for I.07-01-022:

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By Hand Delivery:

Hon. Janice L. Grau
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Executed this 16th day of January, 2008 in San Francisco, California.

/S/ JEANNIE WONG

Jeannie Wong

CALIFORNIA PUBLIC UTILITIES COMMISSION

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